

Tennessee Small Business Investment Company Credit Act Frequently Asked Questions (FAQ)

SECTION 1: GENERAL TNINVESTCO QUESTIONS FOR THE GENERAL PUBLIC

Q 1.1 - What is TNInvestco?

TNInvestco is a state-sponsored, “venture capital type” program in which the state, using a competitive process, has picked ten different firms to provide capital to high-growth, transformational businesses in Tennessee.

Q 1.2 - What is the purpose of TNInvestco?

The goals of TNInvestco are to develop Tennessee’s entrepreneurial infrastructure, bring additional capital into the state, diversify the state’s economy and create “anchors,” or “clusters,” of business innovation that result in the creation or spin off of new companies and the attraction of new talent to Tennessee.

Q 1.3 - How does TNInvestco work?

The state offered \$200 million in gross premium tax credits for future years use to insurance companies that invest in companies qualified by the State of Tennessee as a “TNInvestco”. The TNInvestcos have sold the future years tax credits for up-front capital to invest in Tennessee businesses. The TNInvestco program is administratively housed in the Department of Economic and Community Development.

Q 1.4 - How does my business seek funding by a TNInvestco?

Businesses interested in seeking funding from a TNInvestco are encouraged to view the program requirements and fill out the Web form [here](#). All applications will be submitted directly to the TNInvestcos for consideration.

Q 1.5 - How did the TNInvestco program get started?

After recognizing a need to attract more seed and early-stage capital for Tennessee businesses and entrepreneurs, Governor Phil Bredesen and the Tennessee General Assembly worked to enact the Tennessee Small Business Investment Company Credit Act that created the TNInvestco program on July 9, 2009.

Q 1.6 - Who are the TNInvestcos?

The state has picked ten firms as award winners that are qualified TNInvestcos and two firms that are alternate winners. To view the TNInvestco list [click here](#).

Q 1.7 - What type of companies should apply for TNInvestco funding?

The purpose of the TNInvestco Act is to encourage and support investments in qualified small businesses that have the potential to transform the State of Tennessee's economy. Companies like FedEx and HCA were founded by entrepreneurs and eventually backed by venture capital investors. These companies have had a transformational impact on the state's economy through the jobs, wealth and tax revenues made possible, directly or indirectly, by the efforts of the entrepreneurs that turned vision into reality and the investors that fueled their ambition. The goal of this program is to create opportunities for such economic growth in Tennessee, and the TNInvestco program will only invest in businesses that meet the program's aforementioned goals.

Q 1.8- Do businesses that are interested in being funded by a TNInvestco have to pay any fees?

No, there are no fees that need to be paid to a TNInvestco in order to apply for consideration of funding. Businesses interested in being funded by a TNInvestco can fill out the webform and have their information sent directly to TNInvestco investment managers at http://www.state.tn.us/ecd/tninvestco/start_up_form.html

SECTION 2: ACCESSING INVESTMENT CAPITAL FROM INSURANCE COMPANIES

Q 2.1 – Are participating insurance companies actually investors in a TNInvestco?

Yes. However, there is no requirement that a participating investor take an equity interest in the TNInvestco.

Q 2.2 – Must a participating investor's investment equal the amount of the tax credits awarded to the participating investor?

No. The amount of the tax credit is 100% of the amount allocated to the participating investor by the TNInvestco. The amount of the tax credit is not equal to 100% of the amount invested.

Q 2.3 – Are the tax credits subject to forfeiture or clawback based on the performance of the TNInvestco?

No. The participating investor's investment tax credit is earned and vested upon making its investment in the qualified TNInvestco. The subsequent performance of the TNInvestco has no bearing on the investor's entitlement to the tax credit.

Q 2.4 – May a Health Maintenance Organization invest in a TNInvestco as a participating investor and receive an allocation of investment tax credits?

A participating investor must be an insurance company that is required to pay the gross premiums tax pursuant to Tenn. Code Ann. § 56-4-205. Therefore, if an entity is subject to the gross premiums tax under any other section of the Tennessee Code, then it is not eligible to invest in a TNInvestco as a participating investor and cannot receive an allocation of investment tax credits.

SECTION 3: TAX ISSUES UNIQUE TO TNINVESTCOS

Q 3.1 – Does a TNInvestco incur a federal tax liability when it receives a tax credit allocation from the State of Tennessee?

The Internal Revenue Service is the sole arbiter with respect to federal tax matters. The state will support TNInvestcos seeking clarification from the IRS regarding the proper federal tax treatment of the credit allocation. The state recognizes that federal tax liabilities could reduce the effectiveness of this economic development initiative and will accordingly work with TNInvestcos to minimize any adverse federal tax implications.

SECTION 4: INVESTMENT STRATEGIES FOR TRANSFORMATIONAL OUTCOMES

Q 4.1 – What is a transformational economic development strategy?

The purpose of the TNInvestco Act is to encourage and support investments in qualified small businesses that have the potential to transform the State of Tennessee's economy. Companies like FedEx and HCA were founded by entrepreneurs and eventually backed by venture capital investors. These companies have had a transformational impact on the state's economy through the jobs, wealth and tax revenues made possible, directly or indirectly, by the efforts of the entrepreneurs that turned vision into reality and the investors that fueled their ambition. The goal of this program is to create opportunities for such economic growth in Tennessee. TNInvestcos that receive an allocation of tax credits must propose an investment strategy to make seed and early stage investments in Tennessee small businesses that could potentially transform the state's economy. It is the responsibility of the TNInvestco to communicate its strategy and explain how a successful implementation of its strategy will yield transformational outcomes.

Q 4.2 – The definition of seed or early stage investment allows for exceptions to the general guidelines provided. Is there additional guidance on how this important classification will be adjudicated?

Tenn. Code Ann. § 4-28-102 (15), provides that "seed or early stage investment" means an investment in a company that has a product or service in testing or pilot production

that may or may not be commercially available. The company may or may not be generating revenues and may have been in business less than three years at the time of investment. It is the responsibility of the TNInvestco to demonstrate that a company in which it invests deserves classification as a seed or early stage investment (and thereby receives a 300% multiplier for purposes of meeting the pacing requirements outlined in Section 7 of the TNInvestco Act). Common sense guidelines should apply. For example, an investment in a small business created when an uncommercialized technology was spun out of a large company would most likely merit classification as a seed or early stage investment. In contrast, an investment in a small business created when an established business unit was spun out of a large company would most likely not count as a seed or early stage investment.

Q 4.3 – Tenn. Code Ann. § 4-28-102 (11) (A) (iii) states that a TNInvestco may not invest in the following businesses: legal services; banking or lending; real estate development; insurance; oil and gas exploration; gambling activities; or professional services provided by accountants and doctors. What is the intent of these restrictions?

The restrictions on the types of investments a TNInvestco is permitted to make are intended to deter investment in businesses that typically have ready access to funding. The TNInvestco program is intended to have a transformational impact on the state's economy through the jobs, wealth, and tax revenues of the businesses that are created. Any specific questions regarding types of businesses that could or should be funded through the TNInvestco program should be addressed to the Department of Economic and Community Development.

Q. 4.4- What is the seed or early stage multiplier definition mean in terms of dollars toward reaching the investment thresholds in Tenn. Code Ann. § 4-28-106?

Tenn. Code Ann. § 4-28-106 (a)(1)(B) reads, "Not more than twenty-five percent (25%) of the investment amounts required by subdivisions (a)(1)(A)(i)-(iv) shall be attributable to the three hundred percent (300%) seed or early-stage multiplier." This means that a TNInvestco would have a statutory cap of \$3,150,000 to count toward the investment thresholds. In order to get to the \$3,150,000 cap, the TNInvestco would need to invest \$1,050,000 in approved seed or early stage qualified businesses that would be multiplied by the 300% multiplier for purposes of calculating the investment thresholds.

Ex, Base investment amount: \$14,000,000

X 90%: \$12,600,000 = minimum to be invested by year 6

X 25%: \$ 3,150,000 = cap attributable to multiplier

/ 300%: \$ 1,050,000 = max. seed & early stage cash invested for multiplier

SECTION 5: INVESTMENT TAX CREDITS

Q 5.1 - Will the Department of Commerce & Insurance treat the allocation of the tax credits as an admitted asset on the insurance company's financial statement?

Yes. The Department of Commerce & Insurance issued a bulletin dated August 7, 2009, confirming this treatment.

Q 5.2 – Will a security (i.e., a bond or promissory note) issued by a TNInvestco to a participating investor in connection with the purchase of investment tax credits be treated as an admitted asset?

Since participating funds may structure their deals with insurance companies separately, they should consult with legal counsel regarding this issue.

Q 5.3 – Prior to the 7th anniversary of the fund, may amounts in excess of the base investment amount be distributed following a liquidity event?

Yes. However, a minimum amount must be maintained equivalent to the base investment amount.

Q 5.4 – Is there a requirement that investment capital be reinvested following a liquidity event?

No. However, the capital may be reinvested during the one year redeployment period in order to meet the benchmarks set out in the Tenn. Code Ann. § 4-28-106. In order to comply with the program, the investment levels laid out Tenn. Code Ann. § 4-28-106 must be maintained at all times.

Q 5.5 – Will binding commitments to contribute investment capital be sufficient to meet the \$14 million base amount at the commencement of the program period?

Yes.

Q 5.6 – While the binding commitment must be made at the commencement of the program period, may the actual contribution be made at a subsequent time?

Yes, provided that the benchmarks set out in Tenn. Code Ann. § 4-28-106, are met. This issue potentially impacts federal tax liabilities associated with this transaction. By statute, funds awarded tax credits will work with the state to structure the award of the credit to minimize federal tax obligations.

Q 5.7 – What is meant by the term “cash equivalents”?

“Cash equivalents” is a commonly used financial term that refers to assets that are readily convertible into cash, such as money market holdings, short-term government

bonds or Treasury bills, marketable securities, and commercial paper. The Financial Accounting Standards Board defines “cash equivalents” as highly liquid securities with maturities of less than three months.

Q 5.8 – Is there a requirement that designated capital be in the form of equity?

There is no requirement that designated capital be in the form of equity. Rather, a participating investor may invest money in the form of either debt or equity.

Q 5.9 – Tenn. Code Ann. § 4-28-102 (12) (D) provides that a qualified distribution includes increases or projected increases in certain federal or state taxes of the equity owners of a TNInvestco. How is the amount of a qualified distribution determined in the context of Tenn. Code Ann. § 4-28-102 (12) (D)?

The qualified distribution cannot exceed the actual tax liability due and payable as shown on the investor’s actual return. The request for a qualified distribution related to tax liabilities should be made with supporting documentation, including tax returns, verifying the need.

Q 5.10 – Tenn. Code Ann. § 4-28-108, provides that “investment capital liquidated during a liquidity event will be given a one-year ‘redemption period’ for purposes of calculating the investment thresholds in Tenn. Code Ann. § 4-28-106.” What does this provision refer to?

Investments that result in a liquidity event may potentially result in the fund dropping below the investment threshold in any given year. A one-year period is provided to redeploy funds to maintain compliance with program requirements.

Q 5.11 – Tenn. Code Ann. § 4-28-102 (12) (D) states that a qualified distribution is a distribution or payment not paid to a participating investor, but Tenn. Code Ann. § 4-28-102 (12) (E) states that payments to participating investors are treated as qualified distributions. What is the proper interpretation of this section?

Tenn. Code Ann. § 4-28-102 (12) (E) shall apply, such that a qualified distribution includes any distribution or payment to a participating investor that is in excess of the base investment amount, including any gains from the investment of such base investment amount.

Q 5.12 – Are interest and principal payments to participating investors on debt instruments considered qualified distributions that do not trigger the State Profit Share Percentage as defined in Tenn. Code Ann. § 4-28-102 (10)?

Distributions qualifying under Tenn. Code Ann. § 4-28-102 (12) (E) are not subject to the State Profit Share Percentage.

Q 5.13 – Tenn. Code Ann. § 4-28-106 (a) (2) (e), provides that “any amounts” not invested at the end of the investment period shall be forfeited and paid to the state for use in the Rural Opportunity Fund. Do the words “any amounts” refer to any amounts less than 90% of the base investment amount?

No. As used in this section, “any amounts” refers to any amount less than 100% of the base investment amount. If a TNInvestco elects to not invest the full \$14 million of the base investment amount, the entire uninvested amount must be returned to the state prior to profit-sharing distributions to investors.

Q 5.14 – If a TNInvestco drops below the \$14 million base investment amount as a result of paying qualified distributions like management fees, can 100% of the proceeds from an early investment be used to get the base investment amount back up to \$14 million? That is, is it allowable for 100% of the proceeds to be reinvested and not be subject to the 50/ 50 split?

The TNInvestco must maintain the percentage investment thresholds in Tenn. Code Ann. § 4-28-106. Any non-qualified distributions may not reduce the base investment amount during any calendar year according to Tenn. Code Ann. § 4-28-108. Investment capital liquidated during a liquidity event will be given a one-year redeployment period for purposes of calculating the investment thresholds in Tenn. Code Ann. § 4-28-106.

Example. If an investment was liquidated and put the TNInvestco theoretically below a statutory investment threshold then they would in reality have one year from the date they liquidated the qualified investment to be back in compliance for purposes of calculating the statutory thresholds. Also important to note, according to Tenn. Code Ann. § 4-28-109, at any time that the TNInvestco makes distributions, other than qualified distributions or distributions representing repayments of capital contributions, to its equity investors, the qualified TNInvestco shall pay to the state the profit share percentage (50%).

SECTION 6: GOVERNANCE

Q 6.1 – What level of involvement is required of the Tennessee-based team members?

There is no specific requirement regarding who performs what functions in the investment partnership, however, experience in investing in Tennessee-based companies will be given substantial weight in the decision process.

Q 6.2 – If the TNInvestco fund has more “net proceeds” from the participating investors available to invest than the base amount of \$14 million, may any of the surplus be used to cover costs exceeding the statutory maximum for start-up costs and professional service fees?

No.

Q 6.3 – May the \$500,000 required capital be used to cover costs that exceed the statutory maximum start-up costs of \$125,000?

Yes.

Q 6.4 – May the \$500,000 be returned to the managers if the TNInvestco has more than \$14 million in net proceeds from participating investors?

Yes. However, funds must be available to pay any noncompliance fines or penalties, as these penalties may not be paid for out of tax credit proceeds or gains from investments funded by tax credits.

Q 6.5 – Does the \$50,000 professional service fee maximum include individual portfolio deal expenses?

Yes.

Q 6.6 – May a TNInvestco whose affiliates were previously invested (prior to the allocation date) in an otherwise qualified business make new qualified investments in that business out of TNInvestco funds?

Yes, provided that the entity continues to fulfill its fiduciary duty to the program.

Q 6.7 – Will an individual investment manager's residence in Tennessee for at least five years satisfy the requirement that the TNInvestco have its principal office in Tennessee?

The state realizes that the majority of these entities will be newly formed; we will look at the primary place of business of the individuals managing the investment decisions to make this determination. In the alternative, if the manager is a non-Tennessee resident, we will look to see whether he has five years of experience managing investments in Tennessee companies.

Q 6.8 – Tenn. Code Ann. § 4-28-102 (12) (A) and (C), include certain costs, expenses, and fees in the definition of "qualified distribution." Do the respective \$125,000 and \$50,000 caps for organizational expenses and annual professional service fees double in the event that the TNInvestco receives two allocations?

Yes. The respective \$125,000 and \$50,000 caps for organizational expenses and annual professional service fees are per tax credit allocation. Therefore, the caps are doubled in the event a TNInvestco receives an allocation of two tax credits.

Q 6.9 – Tenn. Code Ann. § 4-28-102 (12) (A) and (C), include certain costs, expenses, and fees in the definition of “qualified distribution.” Is the base investment amount reduced by such qualified distributions?

No. The base investment amount is not reduced by qualified distributions. The definition of "base investment amount" states that the term "means fourteen million dollars in the case of a qualified TNInvestco receiving one allocation ... which must be available in cash or cash equivalents immediately following the investment by a TNInvestco's participating investors and its owners." The definition does not provide a deduction from the base investment amount for management fees, professional services fees, and startup costs.

Q 6.10 – Does the early stage multiplier apply in considering the management fee discussed in Tenn. Code Ann. § 4-28-102 (12) (B) That is, does the multiplier increase the qualified investment for purposes of calculating the lesser of the TNInvestco's base investment amount or its qualified investments?

No. The definition of "qualified investment" states that "seed or early stage investments shall be increased by three hundred percent (300%) for purposes of determining if a qualified TNInvestco meets the investment thresholds in Tenn. Code Ann. § 4-28-106." It does not mention using the multiplier for considering the management fee as discussed in Tenn. Code Ann. § 4-28-102 (12) (B).

Q 6.11 – Is a TNInvestco permitted to make an investment in a qualified business using capital that is not designated capital (i.e., using capital received from investors other than participating investors)?

Yes. Note that the TNInvestco may not invest more than fifteen percent of its designated capital in any one qualified business without the approval of the Department of Economic and Community Development. However, there is no similar limitation on the investment of capital received from investors other than participating investors.

Q 6.12 – Is a manager or affiliate of a TNInvestco permitted to be employed by a qualified business in which the TNInvestco makes a qualified investment? If so, are payments to the manager or affiliate by the qualified business treated as qualified distributions?

A manager or affiliate of a TNInvestco is permitted to be employed by a qualified business in which the TNInvestco makes a qualified investment. Remuneration paid by the qualified business to the manager or affiliate is not considered to be a qualified distribution. However, if the TNInvestco compensates the manager or affiliate directly for services rendered to the qualified business, such compensation will be treated as a qualified distribution.

Q 6.13 – If a TNInvestco affiliate performs interim management services for a qualified business, is the qualified business permitted to compensate the affiliate for such services?

Yes. The qualified business is permitted to compensate the affiliate for services rendered, provided that such compensation does not exceed fair market value. Also, the TNInvestco affiliate is required to report any payment for interim management services that it receives from the qualified business prior to receiving the first payment for approval. Additionally, the TNInvestco affiliate is required to meet with ECD every quarter after a payment was reported for review and if necessary, present the case on why an additional (quarterly) approval is needed.

Q 6.14 – Tenn. Code Ann. § 4-28-109 (b), states that “following the seventh anniversary of the fund,” investment returns may be distributed as liquidity permits (subject to certain limitations). What date is considered the anniversary of the fund: the allocation date, the date of investment of designated capital, or some other date?

The anniversary of the fund falls on the allocation date. The allocation date is the date on which the investment tax credits were allocated to the participating investor(s).

Q 6.15 – May a qualified TNInvestco make a qualified investment in a company if the TNInvestco had previously invested in the company prior to being selected as a qualified TNInvestco?

Yes, assuming that the company in which the qualified investment is made is a qualified business.

Q 6.16 – May a qualified TNInvestco make a qualified investment in a qualified business, when the managers of the TNInvestco also manage a separate fund that is already invested in the same qualified business?

Yes.

Q 6.17 – May a fund make an investment in a qualified business, when the managers of the fund also manage a TNInvestco that is already invested in the same qualified business?

Yes.

Q 6.18 - Can a qualified business be legally organized in another state and be eligible for a qualified investment by a TNInvestco?

Yes, a company can be a legally organized entity in another state and be eligible for a qualified investment as long as they are headquartered in Tennessee and meet the definitions of a “qualified business” in § 4-28-102(10)(A) and § 4-28-102(10)(B).

Q 6.19 - Are there any type of fees that a qualified business may be required to pay at closing?

The State of Tennessee is not a party to the transaction which is just between the qualified TNInvestco and the qualified business however, the transaction must comply with the terms or guidelines laid forth in the TNInvestco statute. A qualified business shall not pay any commitment, finders, broker or other similar type-fee as a term of closing to any qualified TNInvestco. However, a qualified business may pay reasonable and prudent fees normally associated with a venture capital transaction at closing such as legal fees. Any payments from a qualified business to a TNInvestco or its managers should be disclosed to ECD.

Q 6.20 - How does the state define an employee as it relates to the Qualified Business requirements that 60% of employees are located in Tennessee and the company has not more than 100 employees?

The term “employee” means any officer of a corporation, or any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. A company seeking a qualified business designation would need to include an employee if they pay FICA taxes, employee benefits, have the right to hire or terminate or they are controlled solely by the company. Additionally, an employee may be considered for the purposes of this act if the company seeking qualified business designation is part of a subsidiary or has a parent company. Common sense rules should apply and the structure of the deal and flow of funds to company subsidiaries and parent companies should be disclosed to the state for the purposes of determining if the business meets the qualified business definition.

Q 6.21 - What type of expenses are examples of professional services in the Qualified Distribution definition?

A. Professional services are infrequent, technical, or unique functions performed by independent contractors or by consultants whose occupation is the rendering of such services. Examples are accounting, legal, public relations and any other fee that is in accordance with industry custom for ongoing professional service.

6.22 - What are some of the factors reviewed by ECD if a qualified business exception is sought by a TNInvestco to further economic development?

Tenn. Code Ann. § 4-28-106 (b) states "If the department determines that the proposed investment does not meet the definition of a qualified investment, qualified business, or seed or early stage investment, the department may nevertheless consider the proposed investment a qualified investment, or a seed or early stage investment, and if necessary, the business a qualified business, if the department determines that the proposed investment will further state economic development".

The department will utilize the following criteria as the initial basis for considering granting exceptions, but is not limited to this criteria and does not guarantee an exception will be granted in all situations if these criteria are met. The criteria are as follows: 1) Executive leadership in the company is committed to remaining within the state 2) Majority of investors in the company are based in Tennessee 3) Board structure and board members are committed to remaining in Tennessee 3) Company addresses an industry or sector need for the state that may help to recruit or retain certain types of talent and skill sets in which the state is lacking 4) Addresses job needs for rural areas within the state 5) Addresses women and minority participation 6) Capitalizes on strategic partnerships with existing Tennessee businesses 7) The company will produce additional investments through other venture organizations within the state (excluding TNInvestco firms) 8) Company shows promise for high-growth in employment and revenues. Once the Commissioner of Economic and Community Development has reviewed all available information and documentation submitted by a TNInvestco, a determination will be made as to whether an exception will be granted.